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No. 90-741

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

ALETHA DEWSNUP,

Petitioner,

v.

LOUIS L. TIMM, JOHN NEIUWLAND and FLOYD M. CHILDS, Trustees of the UNITED PRECISION MACHINE AND ENGINEERING COMPANY PROFIT-SHARING TRUST, ABCO INSURANCE AGENCY, INC., and JOSEPH L. HENROID, as Trustee for the Annette Jacob Trust,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

STATEMENT

Petitioner owes money to respondents. As security for the debt, respondents have a lien on certain non-resident farmland, a lien that, under Utah law and the security agreement, gave respondents a right to proceed against the property when petitioner defaulted. Petitioner argues that Section 506 of the Bankruptcy Code, 11 U.S.C. § 506, strips respondents of their state-law property right to enforce their lien, even though the farm parcels have been abandoned by the bankruptcy trustee and therefore play no role in this liquidation proceeding.

1. Petitioner, together with her now-deceased husband, executed a deed of trust on June 1, 1978, conveying two farm parcels to a trustee as security for $119,000 in loans. Neither parcel is petitioner's principal residence. Respondents, as the lenders, are the beneficiaries of the trust.[1]

The deed of trust is governed by Utah law. The deed states that, if the borrowers defaulted on their obligations, respondents were entitled to declare the full amount due, to issue a notice of default, and (after an appropriate interval) to have the parcels sold at public auction to the highest bidder, with the proceeds to satisfy the debt owed to respondents (as well as certain other expenses). Deed of Trust ¶¶ 14, 15. Those provisions are mirrored in Utah statutes. Utah Code Ann. §§ 57-1-20 to 57-1-37 (1990).

Petitioner defaulted in 1979.[2] Respondents exercised their rights under the deed of trust and, pursuant to Utah law, gave petitioner 90 days to cure the default, which petitioner failed to do. *See* Utah Code Ann. § 57-1-24. In a state court action, respondents obtained a judgment confirming petitioner's remaining debt to respondents. II R.O.A. 45, 50. Respondents thereupon gave notice of a non-judicial sale to enforce their lien.

In April 1981, before the sale could take place, petitioner filed for bankruptcy protection, seeking reorganization under Chapter 11 of the Bankruptcy Code. That filing stayed the property sale. 11 U.S.C. § 362. Although the 1981 petition was dismissed in 1982, and a second Chapter 11 petition was dismissed in 1984, petitioner filed the present bankruptcy action in 1984 seeking

[1] ABCO Insurance Agency is the only corporation among the respondents. Pursuant to Sup. Ct. Rule 29.1, respondents hereby state that ABCO has no parent company and no subsidiaries except wholly owned subsidiaries.

[2] We hereafter refer only to petitioner, rather than jointly to petitioner and her late husband.

liquidation under Chapter 7. Those successive petitions prevented respondents from exercising their rights under the deed of trust and completing the non-judicial sale.

2. In the Chapter 7 proceeding, petitioner filed a complaint asking the bankruptcy court to divest respondents of their right to proceed against the property. In particular, petitioner sought a declaration, first, that respondents' lien was valid only to the extent of the judicially determined value of the farm parcels and, second, that petitioner had a right under the Bankruptcy Code to redeem the parcels for that amount.[3] Petitioner argued that she was entitled to that relief under Section 506 of the Code, 11 U.S.C. § 506, even though she had no such rights under Utah law.[4] Pet. App. 3a, 16a-17a.

In June 1988, the bankruptcy trustee determined that the parcels were worth less than the lien, which, with interest on the outstanding debt, was then valued at roughly $120,000. The trustee therefore abandoned the property under 11 U.S.C. § 554, because the estate would not receive any net benefit from its liquidation. The same month, the bankruptcy court, after trial, reached a similar conclusion in determining that the parcels had a value of only $39,000. Pet. App. 16a.

[3] Petitioner's complaint did not mention a claimed right of redemption. As the opinions of the bankruptcy court and the court of appeals make clear, however, throughout this litigation petitioner has treated her lien-reduction claim as encompassing her claim for redemption of the property. *See* II R.O.A. 17-18 (trial brief of petitioner). Indeed, whereas she now argues that lien reduction is not the equivalent of redemption (Pet. 12) and purports to pursue only her lien-reduction claim in this Court, in the court of appeals she treated the issues as inseparable, asserting that she sought the right to "avoid liens and effectively redeem real property." Br. of Appellant 5; *see also id.* at 4, 7.

[4] Nothing in Utah law allowed reduction of the lien. Utah law would have allowed petitioner to redeem the parcels within three months of the notice of default. Utah Code Ann. § 57-1-24. Petitioner failed to exercise that right.

The bankruptcy court held, however, that Section 506 of the Code did not apply to the abandoned land, so that petitioner could not, by her action for lien reduction and redemption, deprive respondents of the amount (up to the outstanding debt) the land would bring at a sale, including amounts above the judicially determined $39,000. The court reasoned that, because the property had been abandoned by the bankruptcy trustee in this liquidation case and therefore no longer played a role in the administration of the estate, the property was no longer "property in which the estate has an interest" under Section 506. Any other interpretation, the court explained, would give petitioner more than she would receive outside bankruptcy: petitioner's view would strip respondents of their right to force a non-judicial sale (subject to any state-law redemption rights) and either buy the property themselves or collect the sale price (less certain expenses) up to the value of the outstanding secured debt. Pet. App. 30a. That result would simply give petitioner a windfall for no purpose related to the function of Section 506, which is "to facilitate the administration and distribution of the bankruptcy estate" by valuing and assigning priority to claims to be paid out from the accumulated estate, a process that was not to include this property. Pet. App. 29a; *id.* at 28a. For those and other reasons, the bankruptcy court dismissed petitioner's claim for relief under Section 506, leaving respondents with their state-law rights to proceed against the property. Pet. App. 14a-15a.

The district court affirmed the bankruptcy court's dismissal of petitioner's complaint (Pet. App. 12a-13a), and the court of appeals in turn affirmed (*id.* at 1a-11a). The Tenth Circuit, while relying heavily on the bankruptcy court's reasoning, also explained that petitioner's view of Section 506 would be inconsistent with Section 722 of the Code. Pet. App. 9a-10a. Congress expressly provided debtors a federal right to redeem abandoned property in Section 722, but that provision is expressly

limited to certain kinds of personal property, thus excluding land. Yet allowing lien reduction under Section 506, the court of appeals reasoned, would effectively give the debtor the right to redeem land for the reduced amount (transaction costs aside, a debtor with the money to redeem property could presumably outbid any other bidder at a sale, because the excess price over the reduced lien value would simply be paid back to the debtor). Pet. App. 10a.

The court of appeals acknowledged that the Third Circuit had recently held that Section 506 does apply in a liquidation case to property, such as abandoned property, that is not to be administered in the bankruptcy proceeding. Pet. App. 3a, discussing *Gaglia v. First Federal Sav. & Loan Ass'n*, 889 F.2d 1304 (1989). Explaining its disagreement with *Gaglia*, the court below pointed out that the Third Circuit had failed to recognize that, while Section 506 is not in terms a redemption provision, allowing its use in circumstances like those here would effectively make it one, in conflict with Section 722's restriction of redemption rights to personal property. Pet. App. 10a. The Tenth Circuit also explained that, at bottom, the Third Circuit had relied on the erroneous view that use of Section 506 to strip down the lien reproduced the result that would occur outside bankruptcy (a benchmark that the Tenth and Third Circuits agreed was proper). In fact, the Tenth Circuit explained, a reversion of the property to pre-bankruptcy status—which is what occurs upon abandonment (Pet. App. 5a)—would not limit the lienholders' recovery to the judicially determined price; it would give the lienholders the right to purchase the property themselves or to sell it to the highest bidder (subject to any state-law redemption rights), with the lienholders collecting the sale price (less expenses) up to the amount they are still owed. Pet. App. 7a-8a, 10a-11a. The Third Circuit's reading of Section 506 produces a different result, even though the property plays no role in the bankruptcy.

REASONS FOR DENYING THE WRIT

We recognize that the decision below conflicts with the decision of the Third Circuit in *Gaglia*. It is also clear that the bankruptcy courts are divided on the issue of Section 506's application in a Chapter 7 case to real property that is not to be liquidated, distributed, or otherwise administered in the bankruptcy proceeding. Pet. 8-9. For several reasons, however, we think that review of the issue at this time and in this case is not warranted.

Only two courts of appeals have addressed the question. As the Tenth Circuit (Pet. App. 3a) and Third Circuit (*Gaglia*, 889 F.2d at 1306-07) have both noted, the Seventh and Eleventh Circuits have spoken on related issues, but neither has been presented with the question whether Section 506 applies to abandoned real property in a Chapter 7 case. In *In re Lindsey*, 823 F.2d 189 (7th Cir. 1987), the undersecured lienholder did not challenge the award of a redemption right to the debtor (presumably either because the redemption value was sufficiently close to the amount the lienholder believed it would receive at foreclosure or because the lienholder did not believe that the debtor could acquire the money to exercise the redemption right). In *In re Folendore*, 862 F.2d 1537 (11th Cir. 1989), the court did not address the issue of abandoned property, but the distinct issue of whether Section 506(d), in its pre-1984 version, applies to a lienholder's claim if the bankruptcy court has not disallowed the claim.[5]

In light of the freshness of the conflict at the appellate-court level, we think that it would be advisable to await further developments. For one thing, now that the conflict exists among two courts of appeals, Congress may

[5] It is this latter issue that is expressly mentioned by the single paragraph of *Collier on Bankruptcy* cited by petitioner. Pet. 9 (citing 3 *Collier on Bankruptcy* ¶ 506.07, at 506-75 (15th ed. 1990)). That paragraph does not separately discuss the question of Section 506's application in a liquidation case to abandoned real property.

well step in to clarify the matter. Congress has substantively amended the Bankruptcy Code numerous times since 1978, including Section 506 itself.[6] In enacting those revisions, Congress has shown itself to be closely attentive to problems that arise in the judicial application of the Code.[7] If the present issue is truly a significant one, it can be expected that Congress will take notice and address the matter. Indeed, if the issue is of importance, it is likely to be brought to the attention of Congress by the representatives of major institutional lenders, such as mortgage banks or the lending agencies of the United States (*e.g.*, the Small Business Administration, which was the lienholder in *Gaglia*, or the Farmers' Home Administration, the lienholder in *Lindsey*).[8] There has not yet been an opportunity for that process to work.

There is also new reason for the Third Circuit to reconsider its decision in *Gaglia*. Following suggestions in *Folendore* and *Lindsey*, the *Gaglia* court relied on a

[6] Bankruptcy Judge Lavien noted in 1990 that there has been "almost a yearly significant Congressional input on bankruptcy." Bankruptcy Highlights, in *Bankruptcy Code, Rules and Forms* at vii (West 1990 ed.). *See, e.g.*, Municipal Bankruptcy Amendments, Pub. L. No. 100-597, 102 Stat. 3028 (1988); Intellectual Property Licenses in Bankruptcy, Pub. L. No. 100-506, 102 Stat. 2538 (1988); Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (1988); Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986); Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, § 5001, 100 Stat. 1911 (1986); Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, Title III, 98 Stat. 352-92 (1984); Bankruptcy Act Amendments, Pub. L. No. 97-222, 96 Stat. 235 (1982).

[7] *See, e.g.*, S. Rep. No. 505, 100th Cong., 2d Sess. (1988); S. Rep. No. 119, 100th Cong., 1st Sess. (1987); H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 47, 49 (1986); H.R. Rep. No. 420, 97th Cong., 2d Sess. (1982).

[8] The United States has been involved in many of the cases cited by petitioner (Pet. 8-9), urging that Section 506 does not apply to abandoned real property in Chapter 7 cases.

broad view of the "fresh start" policy of bankruptcy as a reason for holding Section 506 applicable to real property that is not to be administered in the bankruptcy proceeding. 889 F.2d at 1308-09. This Court, however, recently rejected a similar judicial misreliance on an excessively expansive view of the fresh start policy, explaining that the policy does not have independent force that displaces the ordinary means of statutory construction. *Grogan v. Garner*, No. 89-1149 (Jan. 15, 1991), slip op. 7 (reversing decision relying on policy in construing the discharge-exception provision, Section 523, of the Code).

In so doing, moreover, the Court in *Grogan* clarified the limited scope of the fresh start policy: it serves simply to prevent encumbrance of a discharged bankrupt with pre-existing personal debts. Slip op. 7. Yet that policy—in contrast to the broad pro-debtor policy relied on by the *Gaglia* opinion—has no application at all in the present context. Even if the lien retains its full value, the lien runs only against the property, not against the debtor: regardless of the lien, the bankruptcy discharge frees the debtor from the personal debt secured by the lien. The only question is whether the debtor is entitled to be handed a sum of money that represents (non-equity) value of the property realized at a sale. Petitioner's claim for that windfall benefit is a claim not for a "*fresh* start," but for a "*head* start."[9] The Third Circuit should be given the opportunity to reconsider its view in light of *Grogan* (and of the decision in the present case).

In the meantime, there is no pressing need to address the issue presented here. In any given case, what is at stake is the difference between the judicially determined value and the market value of the property (generally, what it would bring at a sale). That difference will be large only if the court's determination is substantially

[9] *Lines v. Frederick*, 400 U.S. 18, 21 (1970) (Harlan, J., dissenting).

inaccurate or if the property has appreciated substantially since the filing of the bankruptcy petition (if that date is used for valuing the property).[10] That the difference is not often large is suggested by the failure of either party to take an appeal in virtually all of the cited bankruptcy-court decisions (Pet. 8-9), including, notably, the failure of the United States to appeal the grant of a redemption right in *Lindsey*. If the stakes are significant in an appreciable number of cases, it is highly likely that a major institutional lender such as the government will bring the matter to this Court (if the conflict persists).[11]

Finally, the Tenth Circuit adopted the proper reading of Section 506, so there is no need for correction of this particular ruling. The bankruptcy court and the Tenth Circuit opinions persuasively demonstrate that the statute is best interpreted not to strip a lienholder of non-bankruptcy property rights—not to give a debtor more than she would be entitled to outside bankruptcy—when the property at issue is not to play any role in the administration of the bankruptcy estate because it has been abandoned in a liquidation case. In these circumstances,

[10] Some of the decisions relied on by petitioner (Pet. 8) indicate that the property is to be valued as of the date of the filing of the bankruptcy petition. *See, e.g., In re Donohue*, 110 B.R. 41, 44 (Bankr. D. Kan. 1990); *In re Lindsey*, 64 B.R. 19, 24 (Bankr. C.D. Ill. 1986); *but cf.* 3 *Collier on Bankruptcy* ¶ 506.04, at 506-37- to -38 (15th ed. 1990). Otherwise, even if petitioner were entitled to lien reduction under Section 506, respondents would be entitled to a new valuation of the property on remand to reflect any appreciation in the value of the property. Petitioner has not suggested that she would accept such a new valuation.

[11] In the present case, the stakes appear to involve between $0 and approximately $15,000. That estimate is based on the difference between the amount of purchase offers that have been received and the amount respondents would receive upon lien reduction, with the latter amount varying according to differing views about how much interest respondents are entitled to add to the figure of $39,000 determined in June 1988.

there is no sound justification for reading Section 506 to disturb the non-bankruptcy property entitlements of the lienholder and to give the debtor the windfall of (non-equity) value of the land. The statutory language was therefore properly given its natural meaning by the court of appeals: the abandoned property, which will play no role in the bankruptcy proceeding, is not "property in which the estate has an interest." 11 U.S.C. § 506(a).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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